Ideas on Innovation

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PENSION FUNDS AND VENTURE CAPITAL:

Linking savings with new ventures

How much are Canadian pension funds contributing to the growth of today's young, cash-hungry, technology-based firms?

In a rare review of Canadian pension fund investment, the Economic Council of Canada concludes that the pension fund industry is looking for liquidity, security and high returns from its investments: traits not usually associated with investment in entrepreneurial and technology-oriented small business sectors.

To gauge the participation of Canadian and U.S. pension funds in venture capital-type investments, IDEA commissioned Mary Macdonald of MPI Consulting to interview managers of major pension funds about the mix in their 1983 investment portfolios. For this issue of "Ideas on Innovation," Ms Macdonald reports her findings and traces the relationship between venture capital investment and the emergence of young, high-growth technology companies on public stock markets.

HOW MUCH VENTURE CAPITAL?

In March 1984, MPI surveyed the 20 largest Canadian and U.S. pension funds to determine the extent of their investments in venture capital. Fifteen Canadian funds responded to the survey, and 16 in the U.S. The majority of the U.S. funds were public-sector based, while only five of the Canadian funds were of this type. The portfolio composition of the funds that responded is summarized in Table 1.

Mary Macdonald, MPI Consulting

The survey showed that the large pension funds in both countries allocate less than half of one percent to venture capital investments. Canadian funds have $72 million in venture capital, or about 9% of comparable investments by U.S. pension funds (without adjusting for currency differentials). In addition, major differences exist between the two countries in terms of the way their large institutional investors approach venture capital opportunities.

> ***"A growing need to keep abreast of rapidly changing technology in an increasingly competitive international environment will, in our view, stimulate business investment... through the balance of the 1980's."***
>
> Canadian Imperial Bank of Commerce, *Canadian Business Conditions*

TABLE 1
Portfolio composition of the largest Canadian and U.S. pension funds, December 31, 1983

	Total assets	Fixed income	Oil, gas & real estate	Investments: Equity Cdn.	Equity Foreign	Venture Capital Syndications	Venture Capital Direct
Canada[1]							
($CDN. millions)	24,849	13,318	1,786	7,472	2,273	41	31
Distribution	100%	54%	7%	30%	9%	0.3%	
U.S.[2]							
($U.S. millions)	215,287	111,004	10,410	93,873 (Total[3])		666	158
Distribution	100%	52%	5%	43%		0.4%	

Notes:
[1] *Includes, in descending order of assets: Canadian National, OMERS, Bell Canada, Hospitals of Ontario, Ontario Hydro, Canadian Pacific, Air Canada, Hydro Quebec, Alcan, Imperial Oil, CBC, Northern Telecom, Ford Canada, Shell Canada and Bank of Montreal.*
[2] *Includes, in descending order of assets: AT&T, California Public Employees, New York State Public Employees, General Motors, California State Teachers, New York State Teachers, General Electric, New Jersey Public Employees, Teachers Retirement System of Texas, Michigan State Employees' Fund, Ohio Public Employees, Ford Motor Company, Wisconsin Public Employees, North Carolina Retirement Board, Dupont and Exxon.*
[3] *Domestic versus foreign breakdowns for equity holdings in U.S. pension funds are not available; most equity investments are domestic.*
Source: *MPI Consulting for IDEA Corporation, March 1984.*

THE U.S. APPROACH

In the U.S., pension funds primarily choose syndicated pools of capital as the investment vehicle. This approach reflects several factors: the confidence of the industry in a small group of experienced independent venture managers; the need to find external agents or "conduits" to flow comparatively large sums of money; and an apparent desire to spread risk across a number of venture investments.

More than two-thirds of 1983 commitments by U.S. pension funds went to venture capitalists with 10 years of direct experience.

A growing alliance and synergy between seasoned venture capitalists and institutional portfolio managers, which may be self-promoting, is evolving in the U.S.

THE CANADIAN APPROACH

By contrast, large Canadian funds made a substantial proportion of their investments in venture capital *directly*, in addition to using the syndication route. Two reasons are evident:

- Tax regulations stipulate that limited partnerships constitute foreign investments, even if the partnerships invest in Canada. Most funds have nearly met their foreign investment limit, which is 10% of total assets.

TABLE 2
Major public-sector pension plans participating in venture investing (U.S., December 1983)

	— $ U.S. millions —		
		Venture Capital	
	Assets	Syndications	Direct
New York State Public Employees	$20,500	70	—
New York State Teachers	$11,100	20	—
Michigan State Employees	$ 8,600	10	40
Ohio Public Employees	$ 8,400	16	68
Total		**116**	**108**

Source: *MPI Consulting for IDEA Corporation, March 1984.*

- The base of venture capitalists with successful track records is evolving slowly in Canada.

Also, the U.S. pension industry's involvement in venture investing is driven by two unique factors. First, leadership is provided by huge pension funds associated with large technology-intensive multinational firms. For example, in 1983, AT&T's pension fund had $270 million (U.S.) invested in venture capital syndications (or almost four times the *total* Canadian pension investment in venture deals).

Second, large public-sector pension funds, in economically troubled regions of the U.S., have provided momentum and mass to venture capital in those regions (Table 2). Comparable developments are few in the Canadian pension industry. Only one of the large public-sector funds is now taking part in venture capital deals.

WHERE DOES VENTURE INVESTING LEAD?

Initial public offerings (IPOs) are an important indicator of an economy's diversification and growth. And they are one vehicle by which the venture capital industry can realize returns on its investments.

The considerable impact of pension contributions to venture capital is readily illustrated: witness the number of young companies going public for the first time on Canadian and U.S. stock markets.

Thanks to the large and sustained involvement of the U.S. pension industry in venture investing, IPOs by small companies, particularly in the technology sector, rose dramatically in the U.S. between 1981 and 1983 (Table 3).

"The U.S. has already shifted to industries of the future, while present policies risk turning Canada into an 'expensive industrial museum...' Among other things, an industrial strategy needs a climate in which private investment and risk taking are encouraged."

Continental Bank of Canada, *Opinion*

TABLE 3
Initial public offerings
Canada and the U.S., 1981-1983

	1981		1982		1983	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Small company offerings[1]	34	390	6	153	42	611
Value ($CDN. millions)[2]	195	3,172	24	1,358	230	7,025
Small company IPOs[3]	15	312	6	122	11	489
Value ($CDN. millions)	83	2,538	24	1,082	97	5,622
# offered through exchange[4]	11	N/A	6	N/A	9	N/A
Small technology co. IPOs[5]	3	146	3	42	10	240
Value ($CDN. millions)	27	1,650	17	726	93	4,732
Venture-backed technology co. IPOs	1	45	0	23	3	101
Value ($CDN. millions)	3	650	0	595	19	2,958

Notes

[1] *Companies with a net worth of $10 million or less prior to offering. Includes only those companies with offering price of at least $1 per share and minimum offering size of $1.5 million.*

[2] *U.S. financings converted to Canadian funds at a rate of $C 1.119 = $U.S. 1.00 in 1981, $C 1.2341 = $U.S. 1.00 in 1982 and $C 1.12324 = $U.S. 1.00 in 1983.*

[3] *U.S. data estimated.*

[4] *U.S. data on number of offerings made through stock exchange not available.*

[5] *U.S. data estimated.*

Source:
MPI Consulting from reports of respective provincial commissions responsible for securities, from corporate interviews, and from Venture Economics.

One in five small company IPOs in the U.S. in 1983 was a technology company with financing provided by a venture capitalist. One hundred and one of these venture-backed young technology companies raised capital in the equity markets in the U.S., compared to three in Canada. Over the last three years, 169 young technology firms with venture capital support have gone the IPO route in the U.S. In Canada, there have been four.

Availability of venture capital from domestic pension funds is not the only reason for the contrast between recent Canadian and U.S. IPO records. Nevertheless, institutional pools of capital are crucial in sponsoring new firms, either directly or using venture capitalists as intermediaries.

"Given the growing importance of institutional investors in capital markets, it is urgent that we find ways of stimulating increased participation by institutions in the development of new product companies."

H. Ian Macdonald, Chairman of the Board, IDEA Corporation

HOW MUCH INFLUENCE COULD CANADIAN PENSION FUNDS HAVE?

If you live in an average Canadian household, close to 40% of your savings are in pension funds and insurance. These savings, perhaps surprisingly, far outstrip investments in bank deposits, stocks and bonds. What isn't surprising, therefore, is that these same pension funds and insurance companies should have a major influence on the growth of companies in this country.

In early 1984, Canadian pension funds had book-value assets of $83 billion, and a quarterly income between $3 billion and $4 billion. These funds are an important potential source of venture capital. In the past, however, they have had little direct involvement in the smaller, entrepreneurial sectors of the economy. Primarily, Canadian pension funds have been providing for the financial needs of government and big companies; since 1980, they have acquired 25% of all securities issued by government and 47% of corporate securities.

The net result is an undercapitalized small to medium-sized Canadian business sector. Canadian pension funds are not now using, to any significant degree, the "basket clause," which allows for venture capital investments. The largest funds surveyed by MPI have a mere 1.4% of assets in basket clause investments, well below the allowed 7% regulatory ceiling.

LINKING PENSION FUNDS WITH NEW VENTURES

Connecting pension funds to the financial needs of young companies has become a theme in the debate over economic restructuring in many industrial countries.

In the U.K. and Denmark, for example, revised regulations and incentives for pension investment are under review because of the evident need to increase funds in the private sector for new business formation and job creation.

In Canada, the link between pension funds and the entrepreneurial sector is developing

gradually through venture capital. This year, for example, Derlan Industries Ltd. was syndicated with $27.5 million in capital from several investors, including IDEA Corporation, and contributions from the pension funds of Air Canada, the Canadian Imperial Bank of Commerce and Bell Canada. Derlan plans to acquire existing undercapitalized Canadian manufacturing firms and upgrade their technological base.

Atlantic Ventures Trust in Charlottetown has similar objectives, using funds provided by the CN Railway pension fund, Ontario Municipal Employee Retirement Board, The Manufacturers Life Insurance Company and Imperial Life Assurance Company of Canada.

HOW WILL THE PENSION FUNDS BENEFIT?

An economy, narrowly based on natural resources, presents limited, and somewhat illiquid, corporate investment prospects for pension fund managers. This is the case in Canada today.

In order to achieve some diversity in their investment portfolios, some in the Canadian pension fund industry are seeking more access to foreign equities that would provide balance and growth potential to their portfolios.

A domestic technology sector, developed, in part, by an infusion of capital from institutional savings, would make it possible for Canadian pension funds to broaden their portfolio base. At the same time, a portfolio consisting of some high-technology investment, *could* have a positive impact on the performance of individual funds.

RRSP contributions are increasing dramatically each year, and Canadian pension funds are seeking more and more viable investment opportunities. In the future, the need for investment outlets for these large funds will be vital.

Now is the time to build an investment framework for the future by directing more venture capital to technology-based startups in Canada's entrepreneurial sector.

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